

Inflation Does Not Fix Anything, Especially Debt

In the ten years prior to the onset of COVID, the consumer prices index rose at an average annual rate of 1.7%. Since the onset of COVID the overall CPI has risen at a 4.2% annual rate. Inflation peaked at about 9.0% back in 2022 but is still hovering between 2.5 and 3.0%, which is above the Federal Reserve's official target of 2.0%.

There are reasons to believe inflation may decline in the year ahead. These include slower growth in the M2 measure of the money supply. While most ignore it, M2 surged 2020-21 signaling the high inflation to come. Since April 2022, it has only grown 2%, signaling the moderation of inflation that the US has seen.

Inflation pushed home prices higher, but the rate of increase has slowed sharply. This could possibly be related to the strict enforcement of immigration laws. Some focus on the fact that fewer workers in construction trades could push up labor costs but forget that it also reduces demand for the existing stock of rental units.

However, there are also some reasons to be concerned about inflation over the medium-term and beyond. It appears that the political consensus in of favor keeping inflation low has eroded. Some economists believe targeting a higher inflation rate (either explicitly or quietly) would give more room for potential growth to expand, while others look back on the pre-COVID trend as risky. With low inflation, interest rates are also lower, meaning the Fed has less room to cut rates in an economic emergency.

If inflation and rates were generally higher, they would have more room to cut rates in another crisis. Perhaps this is why the Fed is considering relaxing capital rules on banks that could free them to lend more aggressively, which would boost the money supply. We have long said that "abundant reserves" are like storing gasoline near your water heater. Cutting capital and liquidity ratios would release some of those reserves.

And this brings us to the most dangerous reason to support inflation. Some think with the national debt at \$38 trillion,

higher inflation would reduce the real value of that debt and make it easier to pay off with inflated dollars.

But we think policymakers would be making a big mistake if they don't wrestle inflation back down and keep it there. Higher interest rates increase the cost of capital, while inflation erodes growth. The Reagan boom happened, in part, because Paul Volcker ran a tight monetary ship which brought inflation down after the high-inflation, and slow growth, 1970s.

Moreover, even though the national debt is officially \$38 trillion, the unfunded liabilities in Social Security and Medicare – the present value of benefit promises to future retirees over and above the expected revenue in these programs – are roughly \$76 trillion. And this form of debt is inflation indexed, in the sense that Social Security benefits are directly indexed to inflation and Medicare spending rises if overall inflation is higher.

So even if higher inflation can temporarily surprise Treasury bondholders, diluting their bonds' value, as shorter-term debt is rolled over, the US will have to pay higher rates on new debt, while not fixing the long-term entitlement problem.

Here's a better idea and one that has proven successful in the past: have the Fed focused on price stability while Congress and the President take measures (together or separately) to get our fiscal house in order. On the latter front, there are some tentative green shoots. In the past twelve months the federal deficit has been \$1.8 trillion versus \$2.0 trillion in the twelve months ending in October 2024.

That's why the next few months of budget battles are important. Will we continue to make (gradual) progress against the deficit? Let's hope so. In the meantime, President Trump is contemplating who he will pick as the next Fed chief. If the next leader is willing to risk higher long-term inflation to try to use monetary policy to fix our long-term fiscal issues, that would be a negative sign.

The US is at a serious inflection point. While many seem to think inflation can help fix it, we don't see how.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-1 / 9:00 am	ISM Index – Nov	49.0	49.1	48.2	48.7
12-3 / 7:30 am	Import Prices – Sep	0.0%	-0.1%		+0.3%
7:30 am	Export Prices – Sep	-0.1%	-0.1%		+0.3%
8:15 am	Industrial Production – Sep	0.1%	0.0%		+0.1%
8:15 am	Capacity Utilization – Sep	77.2%	77.3%		77.4%
9:00 am	ISM Non Mfg Index – Nov	52.0	52.1		52.4
12-4 / 7:30 am	Initial Claims – Nov 29	220K	220K		216K
12-5 / 9:00 am	Personal Income – Sep	+0.3%	+0.4%		+0.4%
9:00 am	Personal Spending – Sep	+0.3%	+0.3%		+0.6%
2:00 pm	Consumer Credit – Oct	\$10.0 Bil	\$9.7 Bil		\$13.1 Bil